UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

JERRY J. AND CORNELIA B. FICKLIN, Debtors.	Case No. 92-57839-MM Chapter 11
JERRY J. AND CORNELIA B. FICKLIN, Plaintiffs, vs. JEFFREY AND LARA FERGUSON, Defendants.	Adversary No. 93-5070 **MEMORANDUM OPINION AND ORDER THEREON**

I. FACTS

In 1990, Jerry and Cornelia Ficklin executed two notes in favor of Jeffrey and Lara Ferguson totaling $190,000. Although both loans matured in 1990, the Fergusons waited until June 2, 1992, to file a civil suit in the San Mateo Superior Court to recover the unpaid balance of the two notes. On September 21, 1992, the Fergusons recorded a Notice of Pending Action against residential real property owned by the Ficklins commonly known as 664 Creek Drive, Menlo Park, California.

On September 28, 1992, the Ficklins requested that the Fergusons release the Notice of Pending Action so that a pending sale may close. As a condition to releasing the notice, the Fergusons required that the Ficklins sign a settlement agreement which states:

For consideration hereby acknowledged and for payment of Ten Thousand Dollars

($10,000) by FICKLIN to FERGUSON, receipt of which is hereby acknowledged, FERGUSON shall dismiss without prejudice Action 377747.... Contemporaneously with the filing of said dismissal, FERGUSON shall cause a release of the Lis Pendens to be recorded in San Mateo County.

The parties signed the Partial Settlement Agreement on October 1, 1992, thus allowing the pending sale to close. However, additional funds in the amount of $13,708.58 had to be paid into escrow to allow it to close. Elsie Begle, the mother of Cornelia Ficklin, held a junior deed of trust on the property securing a loan of $150,000 made to the Ficklins. On October 1, 1992, Ms. Begle signed an Amendment to Escrow Instructions requesting that the funds necessary to close escrow be deducted from her payoff, including interest on existing loans, prorations, billings for repairs, title and escrow related fees, and that the amount of $10,000 be paid to the Fergusons. Ms. Begle relinquished her security interest and now holds an unsecured claim for the additional amount that was required to close escrow.

On November 10, 1992, the Ficklins filed their bankruptcy petition under Chapter 11. Thereafter, the Ficklins filed this adversary proceeding to recover the $10,000 paid to the Fergusons as a preference. They now bring this motion for summary judgment.

II. STANDARD FOR SUMMARY JUDGMENT

In order to prevail on a motion for summary judgment, the moving party must satisfy Fed.R.Bankr.P. 7056, which incorporates Fed.R.Civ.P. 56. Under Rule 56 summary judgment is proper "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c). Only genuine disputes over material facts that might determine the outcome of the suit under the applicable law will properly preclude summary judgment. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 106 S.Ct. 2505, 2510 (1986). A dispute over material facts is "genuine" if the evidence is such that a fact finder could reasonably find in favor of the non-moving party. Id. The non-moving party must therefore counter the motion with specific facts showing that there is a genuine issue for trial. Id.

Summary judgment is proper if a party fails to make a sufficient showing of an element

essential to that party's case, and on which that party bears the burden of proof. Celotex Corp. v. Catrett, 106 S.Ct. 2548, 2552 (1986). For purposes of summary judgment, the moving party bears the initial responsibility of informing the Court of the basis for its motion and of identifying the evidence that demonstrates the absence of a genuine issue of material fact. Celotex, 106 S.Ct. at 2553. The evidence is to be viewed in the light most favorable to the non-moving party and all justifiable inferences are to be drawn in his favor. Anderson, 106 S.Ct. at 2513.

III. ELEMENTS OF A PREFERENTIAL TRANSFER

To avoid a preferential transfer, § 547(b) requires, (1) a transfer of an interest of the debtor in property, (2) on account of an antecedent debt, (3) to or for the benefit of a creditor, (4) made while the debtor was insolvent, (5) within 90 days prior to the commencement of the bankruptcy case, (7) that left the creditor better off than it would have been if the transfer had not been made and the creditor had asserted its claim in a Chapter 7 liquidation. In addition, it must also be established that the transfer of the debtor's property diminished the fund from which creditors may be paid. In re California Trade Technical Schools, Inc., 923 F.2d 641, 645 (9th Cir. 1991). The elements that are at issue in this motion for summary judgment are (1) whether there was a transfer of an interest of the debtor in property, and (2) whether that transfer diminished the estate.

A. Debtors' Interest in Property

Under § 547, a party can recover a preferential transfer of "property of the debtor". 11 U.S.C. § 547(b). The United States Supreme Court has held that "`property of the debtor' subject to the preferential transfer provision is best understood as that property that would have been property of the estate had it not been transferred before the commencement of the bankruptcy proceedings." Begier v. IRS, 496 U.S. 53, 110 S.Ct. 2258, 2263 (1990). The Court went on to further note that "[f]or guidance, then, we must turn to § 541, which delineates the scope of property of the estate and serves as the post-petition analog to § 547(b)'s `property of the estate.'" Id.

The filing of a bankruptcy petition creates an estate comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The

legislative history makes clear that § 541 was intended to be broad in scope. United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05, 103 S.Ct. 2309, 2313 (1983) (citing S.Rep. No. 95-989, p. 82 (1978) and H.R.Rep. No. 95-595, p. 367 (1977), U.S. Code Cong. & Admin.News 1978, p. 5787). However, § 541 is not without limits. The Eighth Circuit has noted:

> [T]he definition was not designed to enlarge the debtor's rights against others beyond those existing at the commencement of the case. In fact, the broad definition of the debtor's estate is modified and limited by subsection (d) of section 541 of the Code. 11 U.S.C. § 541(d) states:
>
> > Property in which the debtor holds, as of commencement of the case, only legal title and not an equitable interest...becomes property of the estate under subsection (a) of this section only to the extent that the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.
>
> Thus, where the debtor holds bare legal title without any equitable interest, the estate acquires bare legal title without any equitable interest.

In re N.S. Garrott & Sons, 772 F.2d 462, 466 (8th Cir.1985). That the scope of § 541(a)(1) is not without limits has also been emphasized by the Supreme Court:

> The legislative history indicates that Congress intended to exclude from the estate property of others in which the debtor had some minor interest such as a lien or bare legal title.

United States v. Whiting Pools, Inc., 462 U.S. 198, 204 n. 8, 103 S.Ct. 2309, 2313 n.8.

The Eighth Circuit in N.S. Garrott summarized § 541 stating, "an interest limited in the hands of the debtor is equally limited in the hands of the estate." *In re* N.S. Garrot, 772 F.2d at 466. Similarly, the Ninth Circuit has ruled that § 541(a)(1)

> merely defines what interests of the debtor are transferred to the estate. It does not address the threshold questions of the existence and scope of the debtor's interest in a given asset.

In re Farmers Markets, Inc., 792 F.2d 1400, 1402 (9th Cir.1986).

The court must look to applicable state law to determine the nature and extent of the debtors' interest in property. Absent a federal provision to the contrary, property rights under § 541 are defined by state law. Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918 (1979).

Under California law, while an escrow is pending and before the conditions of the escrow are performed, neither party to a sale of property acquires title to the property or money deposited by the other party. 2 Miller & Starr, California Real Estate, § 5:7, (2d ed. 1989). Until full performance of

all terms of the escrow agreement, legal title to the assets held in escrow does not pass to the respective parties. See 30 Cal.Jur.3d Escrows § 26 (1987). However, each party to the transaction acquires an equitable interest in the deposit of the other party. See Osborn v Osborn, 42 C.2d 358, 363 (1954); 2 Miller & Starr, California Real Estate, § 5:7, (2d ed. 1989). The case law in California and the treatises on real estate are instructive as to the components essential to the creation of an escrow. However, in determining the interests of the claimants in the escrow funds at issue in this adversary proceeding, decisions in other jurisdictions provide some guidance.

"[W]hether an escrow constitutes property of a debtor's estate depends entirely on the nature and circumstances of the escrow in question." *In re* World Communications, Inc., 72 B.R. 498, 501 (D.Utah 1987). The factors relevant in this determination include, but are not limited to, "whether the debtor initiated and/or agreed to the creation of the escrow, what if any control the debtor exercises over it, the incipient source of it, the nature of the funds put into it, the recipient of its remainder (if any), the target of its benefit, and the purpose of its creation." Id at 500.

The particular nature of the escrow in this case stems from the underlying contract, the escrow agreement, between the parties. The purpose of the escrow is to facilitate the sale of the Ficklins' home and to compensate creditors holding liens on the property. Under the escrow agreement, the Ficklins were entitled only to the escrow funds remaining after payment to these lienholders. Thus, the Ficklins hold a contingent remainder interest with respect to the surplus, if any, remaining after satisfaction of the terms and conditions of the escrow agreement.

In *In re* Dolphin Titan, 93 B.R. 508 (Bankr.S.D.Tex.1988), the debtor placed money into an escrow fund which served to assure payment of worker's compensation claims. The court concluded that "[a]n assurance fund where the debtor has no claim or interest in the fund until all prior claims have been paid in full, is not property of the estate." *In re* Dolphin Titan, 93 B.R. at 512 (citing *In re* Palm Beach, 52 B.R. 181 (Bankr.S.D.Fla.1985)). The court in *In re* Palm Beach also concerned an escrow arrangement where the fund was established to assure that the debtor performed certain obligations. The Palm Beach court also concluded that the assurance fund was not property of the estate:

Any claim, contingency or chose in action against the trust fund is the property of the

> estate but the fund itself is not. The debtor may not have any part of said fund until such time as the debtor establishes that all prior claims in the fund have been paid and that a residuum remains to which it is entitled. Id at 183.

This rule comports with the conclusion reached by the Eighth Circuit in *In re* Newcomb, 744 F.2d 621 (8th Cir.1984), where the court noted, in interpreting Missouri law, that "an escrow is something more than a contract, it is a method of conveying property. When property is delivered in escrow, the depositor loses control over it, and an interest in the property passes to the ultimate grantee under the escrow agreement." Id at 624. Further, the court noted that "once the escrow was created, the only interest in the escrow funds remaining in the debtor was a contingent right to the funds..." if the conditions of the escrow were satisfied. Id at 627.

Applying the foregoing analysis, the court concludes that the escrow funds that were used to compensate the Fergusons are not property of the Ficklins' bankruptcy estate. The Ficklins merely had a contingent remainder interest in the escrow funds, which did not vest in the debtors upon fulfillment of the conditions in the escrow agreement. Once claims upon the Ficklins' property were satisfied, the Ficklins would then be entitled to receive the balance of the fund, if any. The Ficklins assert that under the Amendment to Escrow Instructions signed by Ms. Begle, they are entitled to the money effectively made available by this arrangement. However, these funds cannot be characterized as "residuum" since fulfillment of the conditions of the escrow agreement did not occur prior to signing the Amendment. The sum that Ms. Begle agreed to forego and that was paid to the Fergusons facilitated the satisfaction of the conditions of the escrow agreement which thereafter entitled the Ficklins to any remaining funds held in escrow.

The transfer of the escrowed funds was not a transfer of property of the debtor and is not recoverable by the Ficklins as a preference. This conclusion comports with the principles of property of the estate. As the Eighth Circuit noted in N.S. Garrott, "an interest limited in the hands of the debtor is equally limited in the hands of the estate." 772 F.2d at 466.

B. Earmarking Doctrine Exception

The earmarking doctrine is a court-made interpretation of the statutory requirement that a voidable preference must involve a "transfer of an interest of the debtor in property." *In re* Bohlen

Enterprises, Ltd., 859 F.2d 561, 565 (8th Cir. 1988). When new funds are provided by the new creditor to or for the benefit of the debtor for the purpose of paying the obligation owed an old creditor, the funds are said to be "earmarked" and the payment is held not to be a voidable preference. This is held to be true even if the funds pass through the debtor's hands in getting to the selected creditor. See *In re* Montgomery, 983 F.2d 1389 (6th Cir. 1993).

Although accepted as a valid defense to preference claims, this issue need not be addressed in the instant case. The applicability of this doctrine rests upon the conclusion that the debtor held an interest in the subject property. In the present case, this Court has concluded that the escrow funds that were used to compensate the Fergusons are not property of the Ficklins' bankruptcy estate. The Ficklins had a contingent remainder interest in the escrow funds which did not vest in the debtors upon fulfillment of the conditions in the escrow agreement. Since the preference claim lacks this essential element required by § 547, the earmarking defense becomes a moot issue.

C. Diminution of the Estate

Beyond the issue of whether an interest of the debtors in property was transferred is the requirement that the transfer diminishes the fund from which creditors may be paid. *In re* California Trade Technical Schools, Inc., 923 F.2d 641, 645 (9th Cir. 1991); See also *In re* Bullion Reserve of North America, 836 F.2d 1214, 1217 (9th Cir.), *cert. denied*, 486 U.S. 1056, 108 S.Ct. 2824 (1988) ("Generally, property belongs to the debtor for the purposes of § 547 if its transfer will deprive the bankruptcy estate of something which could otherwise be used to satisfy the claims of other creditors.").

In Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir.1986), *reh'g denied* 801 F.2d 398 (5th Cir.1986), cited by both the Plaintiffs and Defendants, an indirect offshore subsidiary of the debtor deposited with the bank creditor $35,000,000 as collateral for its parent's loan obligations. Within the 90 day preference period, the subsidiary instructed the bank to transfer the money to its debtor parent's account. On the same day, the debtor directed the bank to apply the full sum to repay its loan obligations. The Fifth Circuit stated:

If all that occurs in a "transfer" is the substitution of one creditor for another, no

> preference is created because the debtor has not transferred property of his estate; he still owes the same sum to a creditor, only the identity of the creditor has changed. Id. at 1356.

The facts of the instant case are analogous to the circumstances in Coral Petroleum. The money deposited by the subsidiary in Coral Petroleum extinguished the parent corporation's debt to the bank creditor while creating an equivalent obligation to the subsidiary. The evidence failed to demonstrate that the debtor parent corporation's estate suffered any diminution. It was asserted that when the deposit was made in the debtor parent's account at the bank creditor, the debtor "theoretically had general control over these funds for at least one `magic moment'... [when the debtor] could theoretically have made payments to its general creditors (although it did not do so or attempt to do so)." Id at 1359. The Court rejected the conclusion that the estate was thereby diminished and that there was a preference. The Court stated:

> Here there was no magic moment - there were merely simultaneous bookkeeping entries reflecting the credit and debit to the [debtor] account and to the [subsidiary] account...No evidence was presented...that [the debtor] at any time had control over these funds, even for a moment. Id at 1360-61.

Similarly, the Ficklins have failed to provide sufficient evidence establishing a diminution of the bankruptcy estate caused by the transfer of funds to the Fergusons. As was asserted in Coral Petroleum, the Ficklins contend that the funds paid to the Fergusons could have been used to pay their other creditors. However, they have provided this court with no evidence to support this assertion. In addition, this court can find no diminution of the debtors' estate where there was merely a substitution of Ms. Begle for the Fergusons as an outstanding creditor. The amount made available by Ms. Begle facilitated the close of escrow and settled the Ficklins' debt to the Fergusons, which arose from the Partial Settlement Agreement. However, although Ms. Begle relinquished her security interest in the Ficklins' sale proceeds by signing the Amendment to Escrow Instructions, she did not relinquish her claim.

IV. CONCLUSION

For the foregoing reasons the Plaintiffs' motion for summary judgment must be denied.

Good cause appearing, IT IS SO ORDERED.